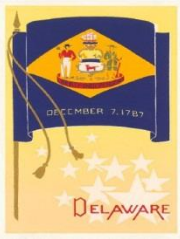
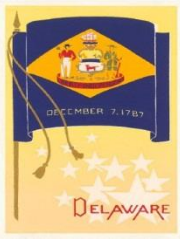

A Review of Delaware's Revenue Portfolio

Presented to the Advisory Council on Revenues
January 16, 2015

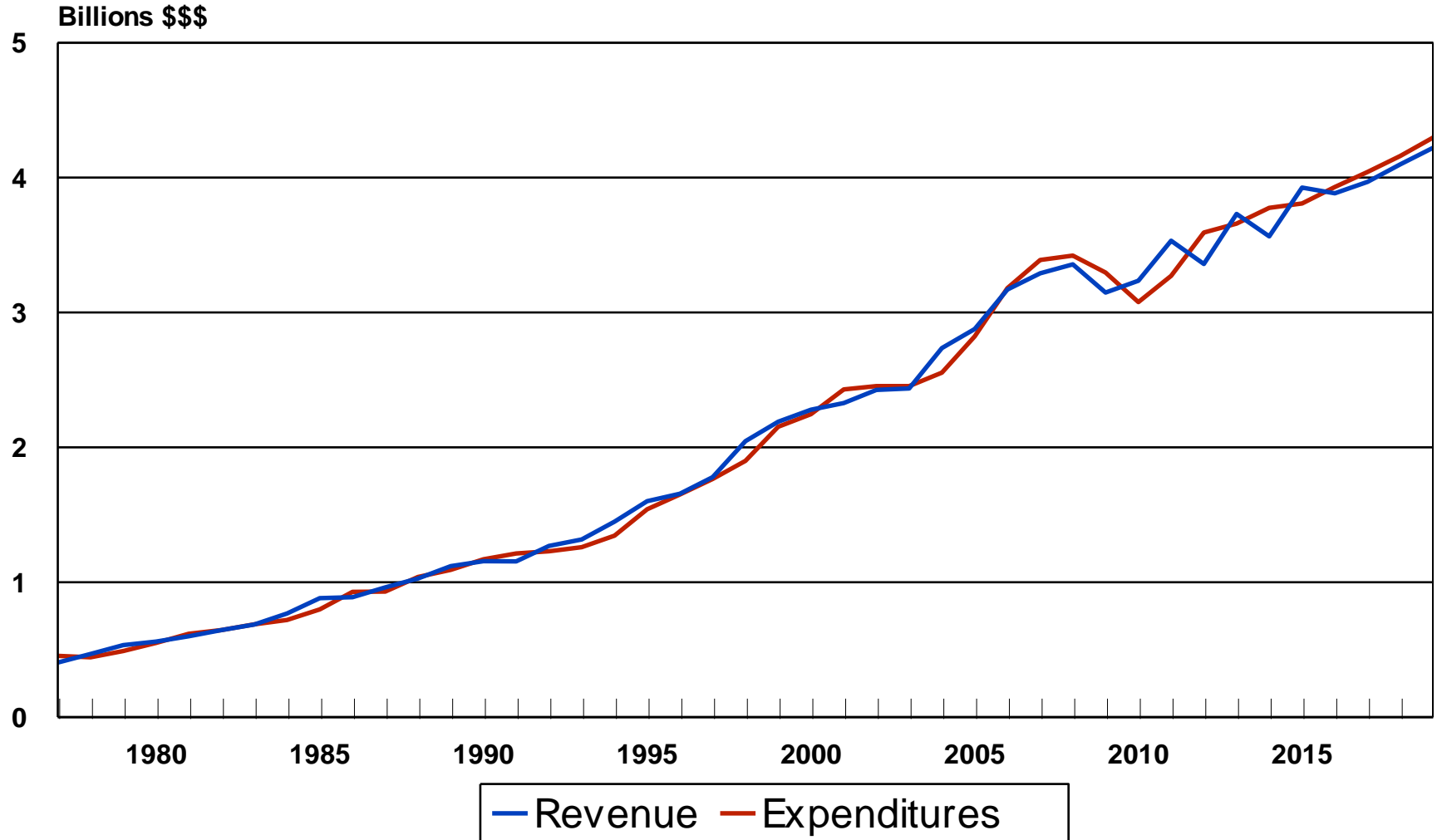


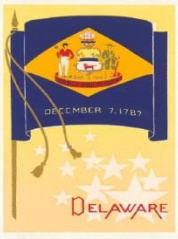
Purpose

- Recognition of broad fiscal challenges
 - New normal for U.S. economic growth
 - Demographic pressures
 - Not unique to Delaware
- Consensus on Delaware specific issues
 - Revenue system with unique benefits and challenges
 - Need for better understanding
- Consensus on approach
 - Transparent, inclusive, bi-partisan and objective



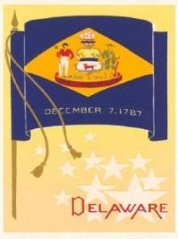
State of Delaware General Fund 1977-2019





Building Imbalance

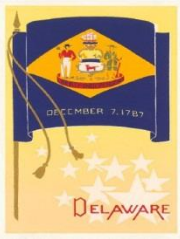
- Despite building economic momentum, Delaware's budget projections suggest a growing imbalance.
 - Revenue growth is constrained by sources that are less responsive to economic prosperity.
 - Expenditure pressures fueled by mandatory outlays driven by national trends.
- The potential for imbalance in better economic times suggests structural measures need to be taken.



Scope

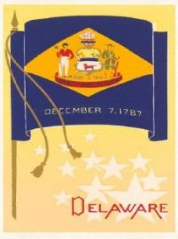
- Large topic and ambitious timeframe requires focus
- State revenues supporting the General Fund
 - Avoid duplication of lottery, escheat and TTF studies.
- Focus on revenue sources' adequacy, stability and economic competitiveness.

Tax Policy Criteria



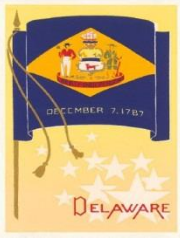
Tax Policy Criteria

- Adequacy and Stability – the ability to raise revenue in a reliable manner
 - ✓ Growth – keeping pace with cost of providing services
 - ✓ Stability – dependable and predictable
- Fairness in the distribution of the tax burden
 - ✓ Ability-to-pay
 - ✓ Benefits received
 - ✓ Horizontal equity- treating equals equally
 - ✓ Vertical equity - treating unequals fairly



Tax Policy Criteria

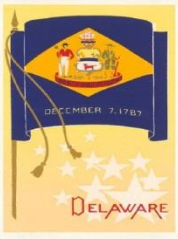
- Simplicity – Ease of administration, enforcement, and compliance
- Economic efficiency / neutrality – the level of interference with individual decision-making
- Economic competitiveness – the degree to which a tax promotes or hinders economic growth



Tax Criteria and the Portfolio Approach

- Tax policy criteria sometimes conflict
 - Vertical equity vs. efficiency
- Within the adequacy and stability criterion there is often a trade-off between growth potential and stability
- No single “perfect” tax
- A revenue portfolio should be balanced and diverse

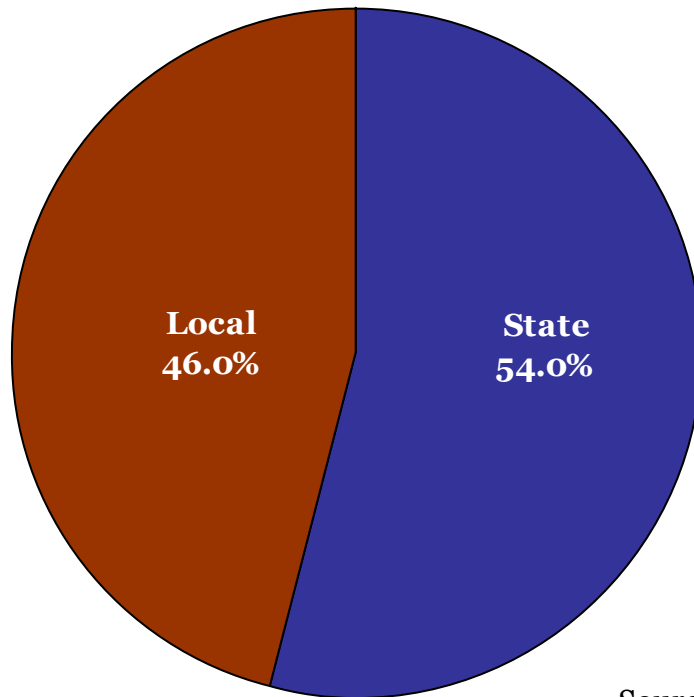
Delaware's Fiscal System



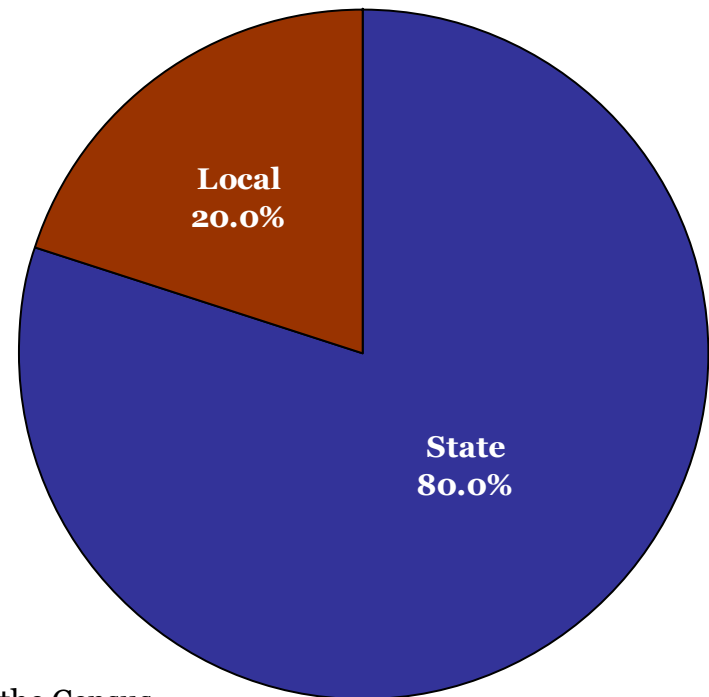
Delaware's system is “centralized”

FY 2012 Share of Own Source Revenues

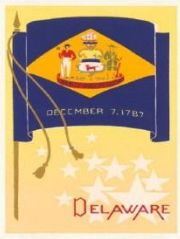
Average of all States



Delaware

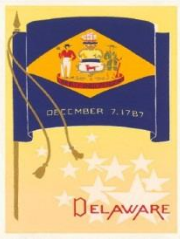


Source: U.S. Bureau of the Census



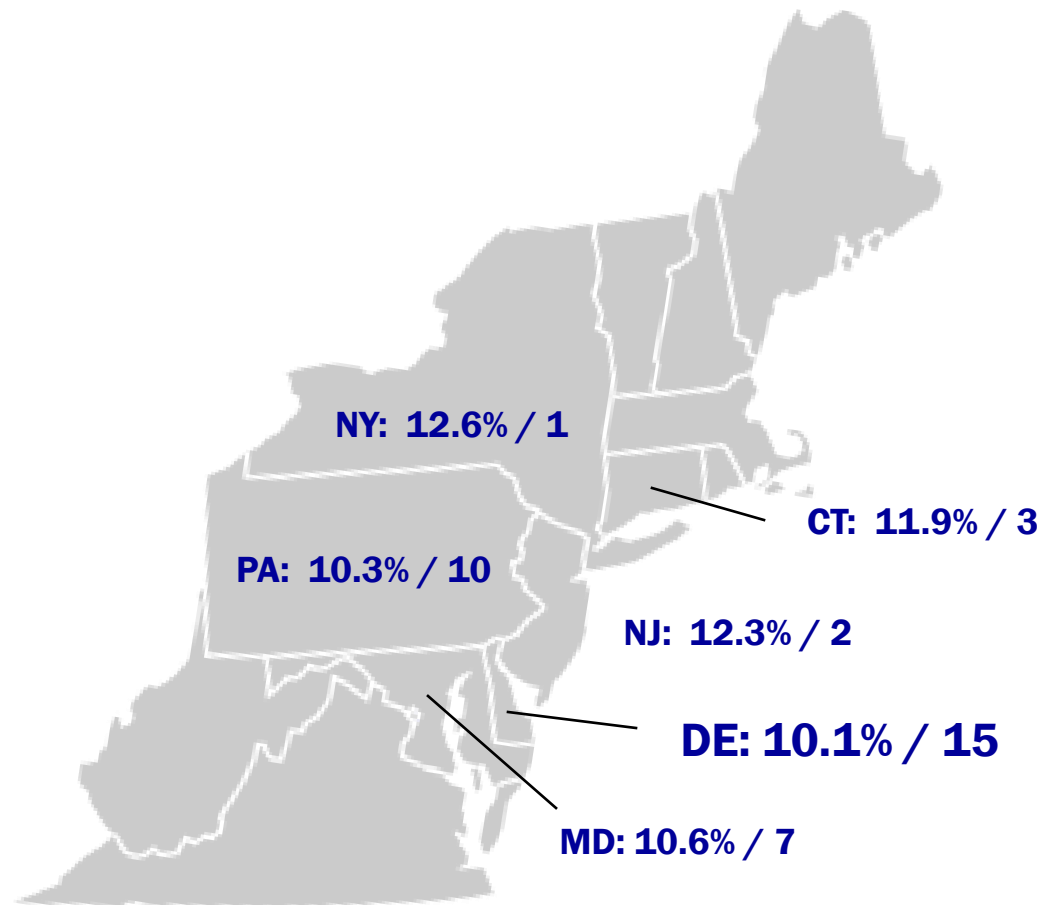
And unique

- Low property taxes
 - 4th lowest as a share of median house value
 - 6th lowest payment per capita
- No sales tax (no local share)
 - State-level gross receipts tax
- Corporations' legal home
 - Reliance on related taxes & fees
- Non-tax revenues -- lottery & abandoned property



And, according to the Tax Foundation competitive with other states

State & Local Tax Burden 2011 Percentage of Income / Ranking (highest to lowest)

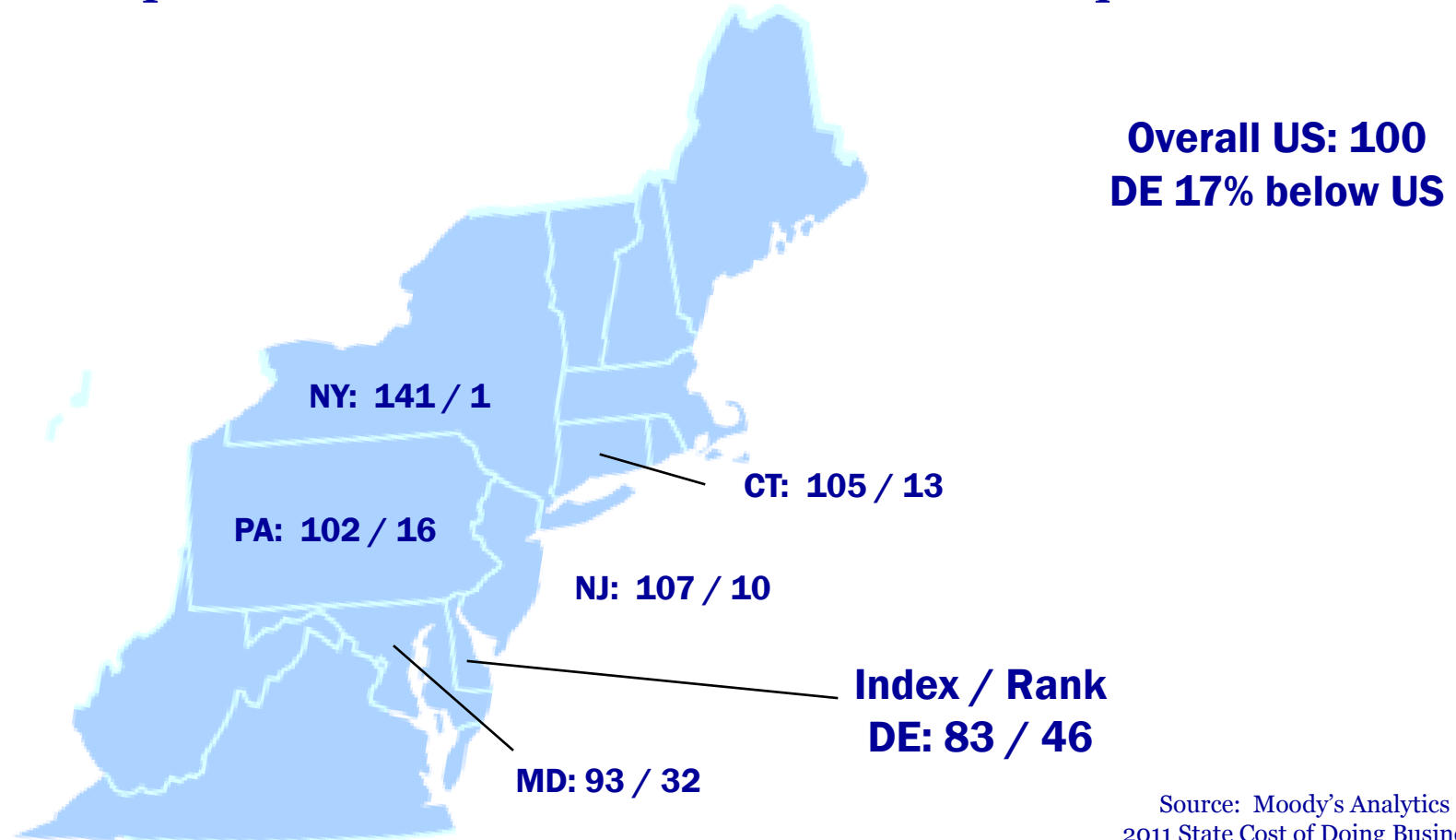


Overall US: 9.8%
DE 103% of US

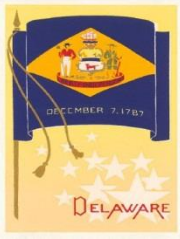


Or, according to Moody's Analytics among the most competitive in the nation

State & Local Tax Burden
Expressed as an Index where Overall US equals 100



Source: Moody's Analytics
2011 State Cost of Doing Business
October 2013



But supports relatively high levels of spending

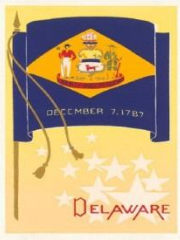
- FY 12 State & Local Per Capita Direct General Expenditures
 - 7th Highest in US

| | | |
|----|----------------------|--------|
| 1 | Alaska | 17,301 |
| 2 | District of Columbia | 16,952 |
| 3 | Wyoming | 13,383 |
| 4 | New York | 12,125 |
| 5 | North Dakota | 10,275 |
| 6 | Vermont | 9,961 |
| 7 | Delaware | 9,862 |
| 8 | Connecticut | 9,563 |
| 9 | Massachusetts | 9,524 |
| 10 | New Jersey | 9,354 |

Overall U.S. 8,237

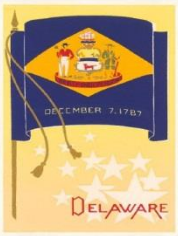
Source: US Census Bureau

- 2012 Census of Governments: State & Local Finances
- Population Estimates, State Totals: Vintage 2014



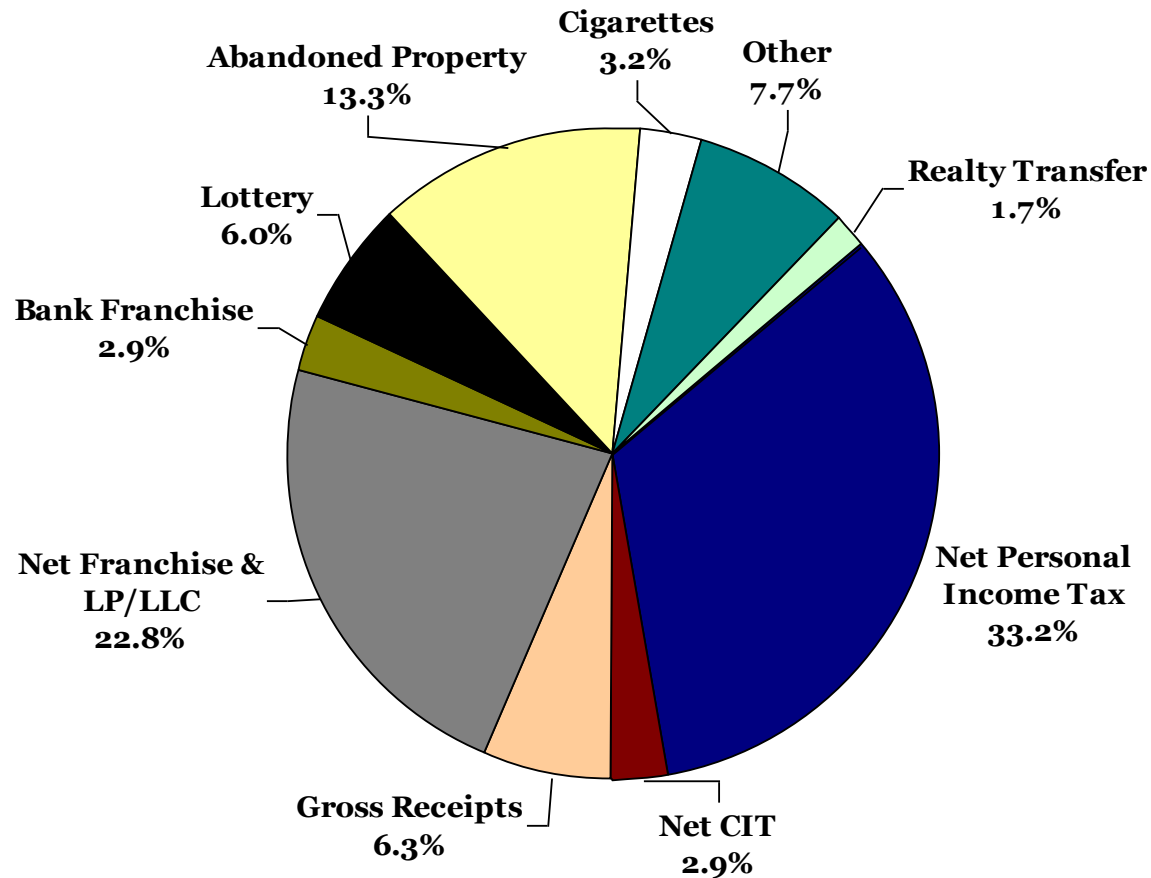
Explanation

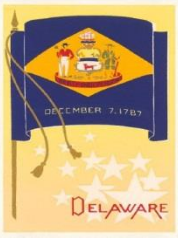
- Not all revenue sources are taxes
- Legal vs. Economic Incidence
 - Who writes the check vs. who actually pays the tax.
- Exported Tax Burden
 - Alaska: Oil tax is passed along to consumers in other states
 - Nevada: Lodging & gaming taxes passed along to tourists from other states
- Delaware
 - Corporations, Casinos, Credit Cards, Cigarettes, Consumers (tax-free shopping), Center for jobs



General Fund Revenues FY 2014

Total Revenue Net of Refunds: \$3,572.7 million.

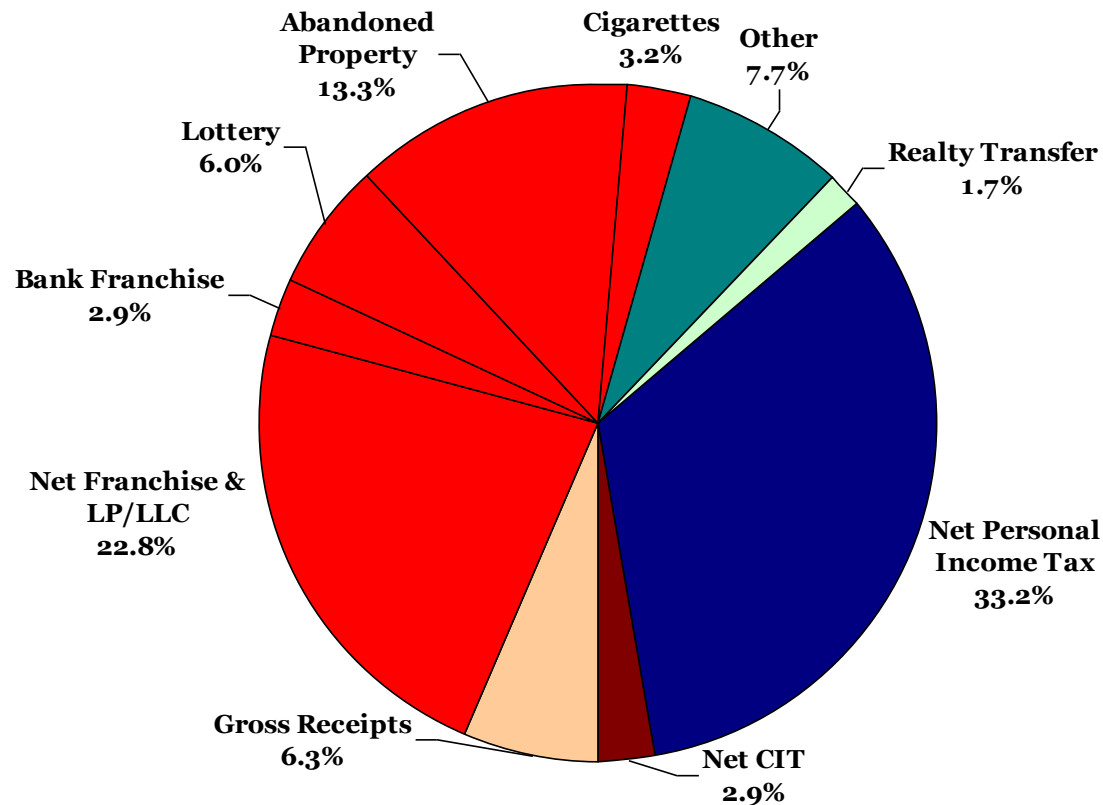


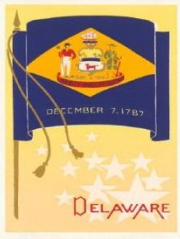


General Fund Revenues

FY 2014

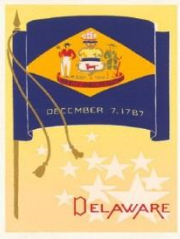
Total Revenue Net of Refunds: \$3,572.7 million.





Summary & Implications

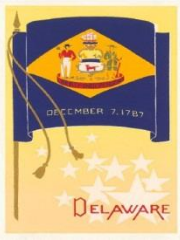
- Exported revenue burden
 - Relatively low taxes + high spending/services
- Unique system means unique risks
- National conformity brings national risks
- Policy consequences
 - “Silver bullet” mentality



Why is this a problem now?

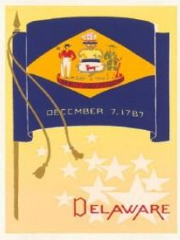
- DE system has been in place for decades
- What is different now?
 - Economic and demographic headwinds
 - Lottery and unclaimed property challenges
 - Limitations on Delaware’s corporate “well”
 - Capacity of remaining sources to compensate in question

Measuring Revenue Adequacy



Elasticity

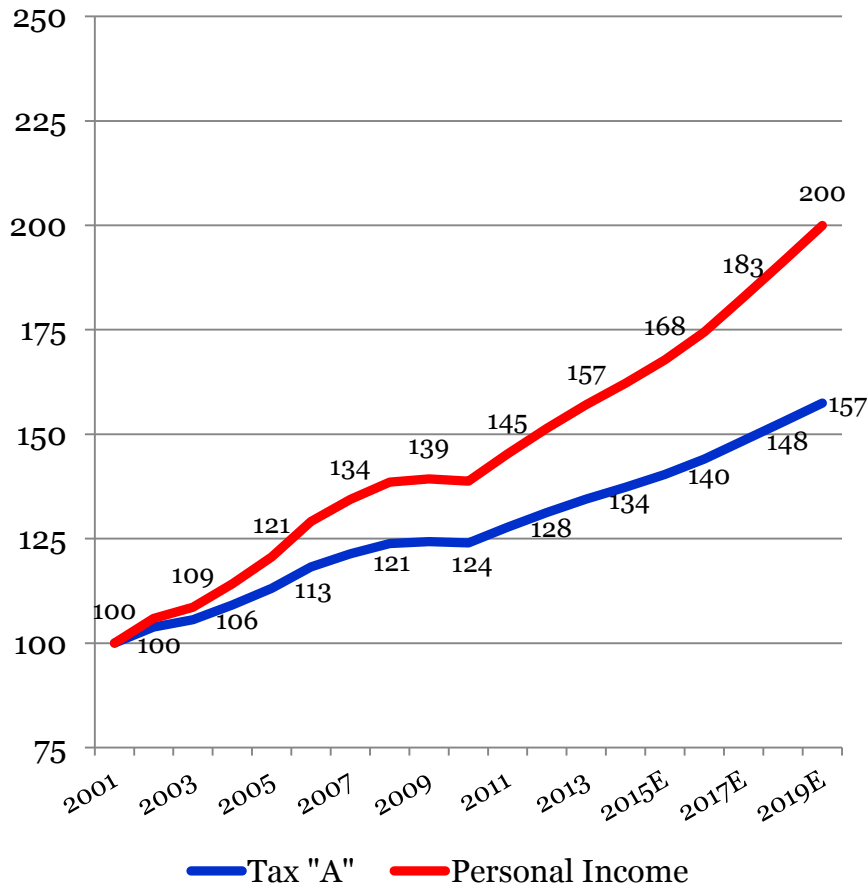
- How much revenue responds when the economy shifts
 - Typically use personal income as proxy for the economy
 - Elastic: $\Delta \text{Revenue} \Delta \text{Economy}$
 - Inelastic: $\Delta \text{Revenue} \Delta \text{Economy}$
 - For example, an elastic revenue source increases by 2% when personal income grows by 1%.
 - This elastic revenue source helps Delaware expenditure keep pace with the demands of a growing economy.



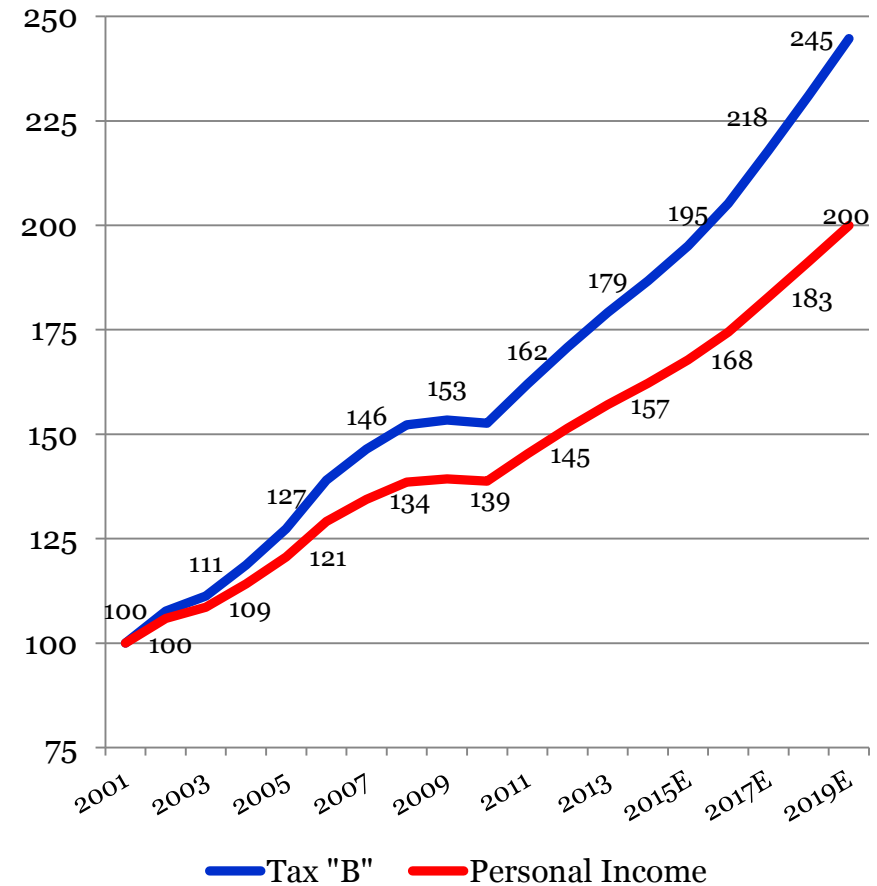
Elasticity expressed as an Index

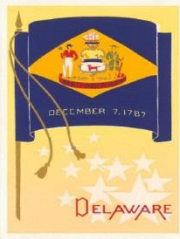
Tax "A" is Inelastic

2001 = 100



Tax "B" is Elastic





Revenue Growth and Stability: Recent History

Performance of Major Revenue Categories: FY 1997-2013

(General Fund Revenues Adjusted For Delaware Legislative Changes)

| Revenue Source* | Share of FY 2013 Revenues | STABILITY | | | | | | GROWTH HISTORY | | | | GROWTH FORECAST | |
|---------------------------------|---------------------------|--|------|------------------------|------|-------------------------------|------|---|------|--|------|--------------------------|------|
| | | ranked from most stable (1) to least stable (8) | | | | | | Ranked from highest growth/elasticity (1) to lowest (8) | | | | | |
| | | Years with Negative Growth in Last 17 Fiscal Years | | Standard Deviation (1) | | Coefficient of Variations (2) | | Estimated of Annual Growth Rate (3) | | Elasticity v. Delaware Personal Income | | Elasticity Over Forecast | |
| | | Value | Rank | Value | Rank | Value | Rank | Value | Rank | Value | Rank | Value | Rank |
| Personal Income Tax | 31% | 6 | 4 | 182.5 | 8 | 21.28615 | 2 | 4.83% | 4 | 0.89 | 4 | 1.08 | 2 |
| Corporate Franchise & LLC/LLP's | 16% | 4 | 2 | 98.9 | 6 | 13.78962 | 1 | 2.74% | 6 | 0.50 | 6 | 0.59 | 5 |
| Corporate Income Tax | 5% | 7 | 5 | 39.2 | 3 | 33.69179 | 6 | 4.86% | 3 | 0.94 | 3 | 1.16 | 1 |
| Bank Franchise Tax | 3% | 9 | 8 | 25.0 | 2 | 24.25522 | 3 | 2.32% | 7 | 0.12 | 7 | 0.20 | 6 |
| Gross Receipts Tax | 6% | 3 | 1 | 42.8 | 4 | 26.5954 | 5 | 5.44% | 2 | 1.16 | 2 | 1.01 | 3 |
| Abandoned Property | 15% | 5 | 3 | 150.7 | 7 | 51.09333 | 8 | 13.40% | 1 | 2.44 | 1 | -0.17 | 7 |
| Realty Transfer Tax | 1% | 7 | 5 | 22.6 | 1 | 42.23646 | 7 | 2.84% | 5 | 0.61 | 5 | 0.71 | 4 |
| Cigarette & Tobacco Product Tax | 3% | 8 | 7 | 47.6 | 5 | 25.99496 | 4 | -1.51% | 8 | -0.22 | 8 | -0.69 | 8 |

Weighted GF Elasticity ==>

0.84

Weighted GF Elasticity (no escheat) ==>

0.47

Forecast Weighted GF Elasticity ==>

0.51

Forecast Weighted GF Elasticity (no escheat) ==>

0.54

* Lottery Revenues are not included.

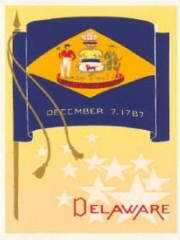
(1) Standard Deviation revenues in millions adjusted for Delaware legislative changes.

(2) Coefficient of Variation is defined as the (standard deviation/mean).

(3) Natural log of revenues in millions adjusted for Delaware Legislative changes.

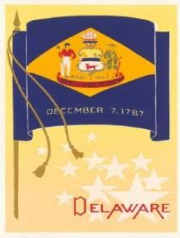
(4) Natural log of revenues in millions adjusted for Delaware Legislative changes vs. natural log of Delaware Personal Income.

Tax Policy at its Most Basic



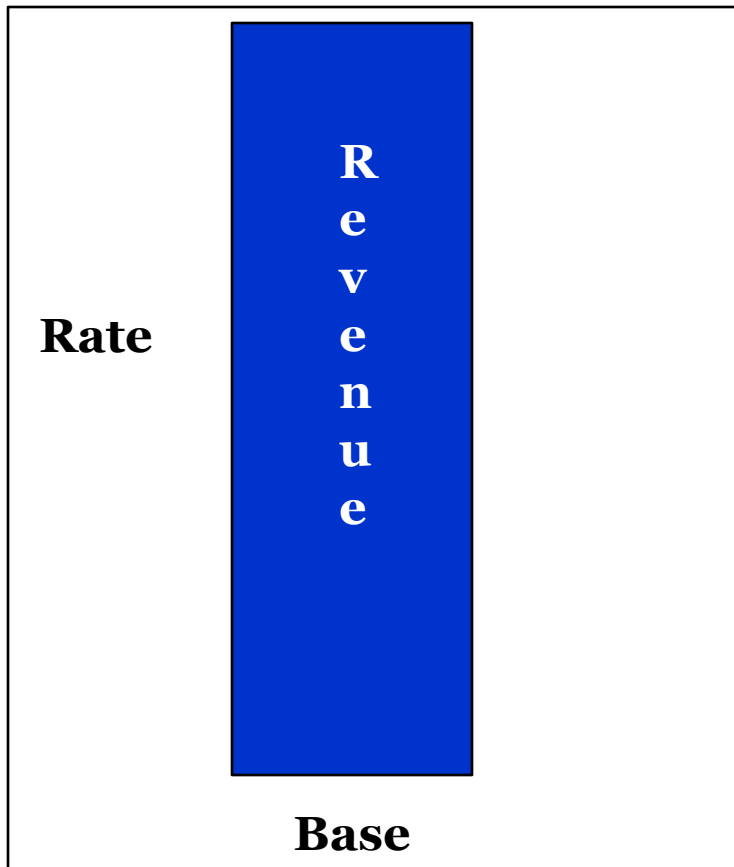
All taxes have two parts...

1. Tax Base – that which is subject to tax
 - Income, sales, property value
 2. Rate – the share of the base owed
 - Marginal, effective
 - Progressive, regressive
- Where do non-tax revenues fit?

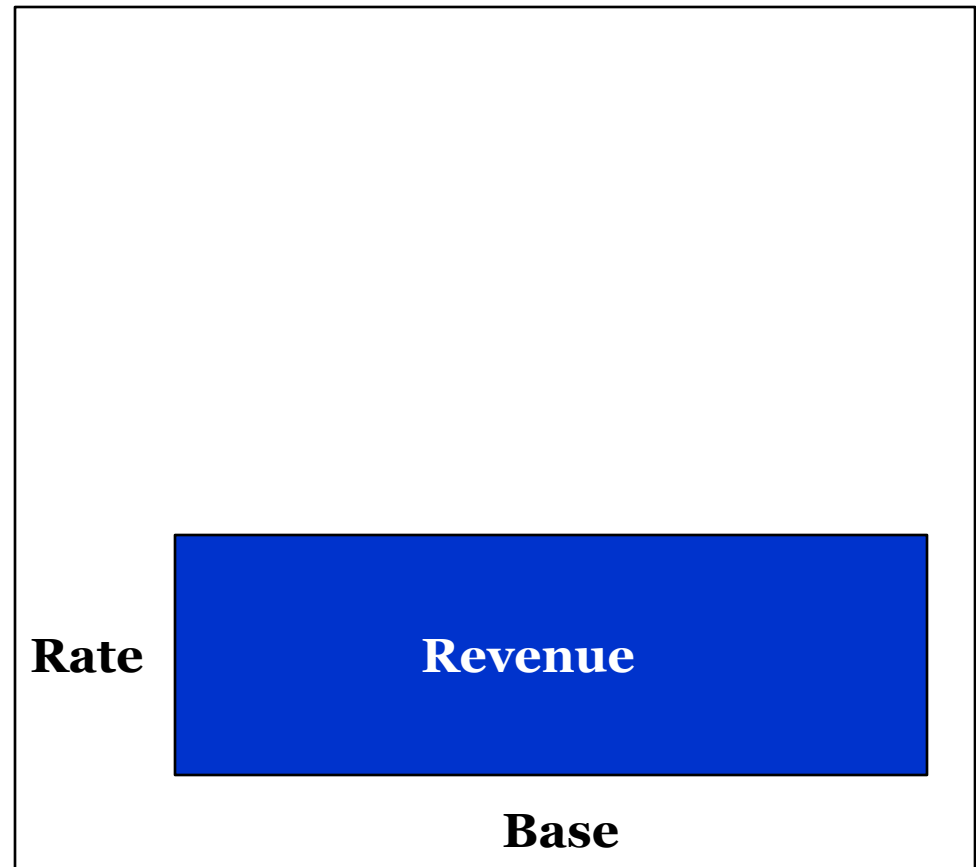


Broad Base, Low Rate & Stability

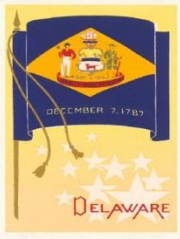
Narrow Base + High Rate



Broad Base + Low Rate



Detailed Revenue Structure



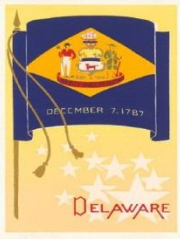
Personal Income Tax

Cyclical Issues

- Employment / Wage growth
- Securities markets / Capital gains

Structural Issues

- New normal
- Demographics + senior tax breaks = \$100+ mm issue
- Shifting income distribution
- Federal piggyback



Demographic Pressure

Budgetary Impact (millions)

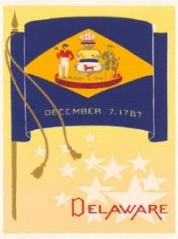
| | Fiscal <u>2004</u> | Fiscal <u>2014</u> |
|---|-----------------------|-----------------------|
| Income Tax Provisions | | |
| Retirement Income Exclusion (Age 60+ \$12,500 per individual) | \$29.5 | \$51.9 |
| Social Security (Exclusion of federally taxable portion) | 16.0 | 42.0 |
| Additional Standard Deduction (Age 65+ \$2,500) | 2.5 | 4.0 |
| Additional Personal Credit (Age 60+ \$110) | 5.5 | 10.0 |
| Elder School Tax Subsidy | <u>10.8</u> | <u>22.2</u> |
| Total | <u>\$64.3</u> | <u>\$130.1</u> |



Incrementalism & Unintended Consequences

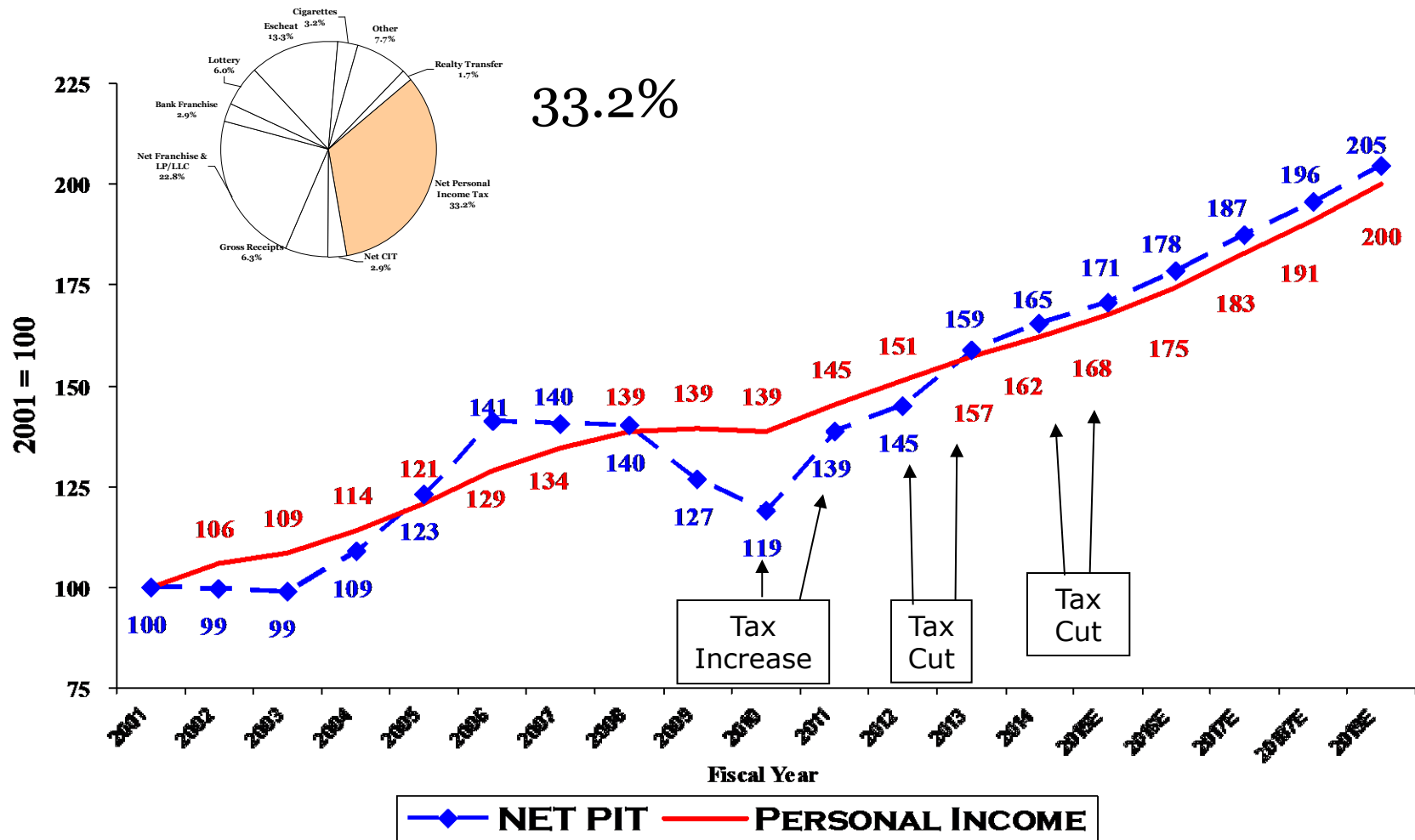
Personal Income Tax Liability Comparison: Two \$80,000 Income Households

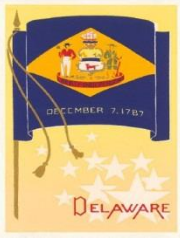
| | <u>Working-Age Family of Four</u> | | <u>Retired Couple</u> | |
|--------------------------------------|-----------------------------------|----------------------|-----------------------|----------------------|
| | <u>First Spouse</u> | <u>Second Spouse</u> | <u>First Spouse</u> | <u>Second Spouse</u> |
| Wages | \$40,000 | \$40,000 | \$0 | \$0 |
| Retirement Income | - | - | 26,000 | 26,000 |
| Social Security | - | - | 14,000 | 14,000 |
| Total Income | \$40,000 | \$40,000 | \$40,000 | \$40,000 |
| Exclusions | | | | |
| Retirement Income (Age 60+) | - | - | (12,500) | (12,500) |
| Social Security (Age 62+) | - | - | (14,000) | (14,000) |
| Delaware AGI | \$40,000 | \$40,000 | \$13,500 | \$13,500 |
| Standard Deduction | (3,250) | (3,250) | (3,250) | (3,250) |
| Additional Std Deduction Age 65+ | - | - | (2,500) | (2,500) |
| Taxable Income | \$36,750 | \$36,750 | \$7,750 | \$7,750 |
| Gross Tax Liability (Before Credits) | \$1,653 | \$1,653 | \$173 | \$173 |
| Personal Credits (\$110 per person) | (330) | (110) | (110) | (110) |
| Additional Personal Credit Age 60+ | 0 | 0 | (110) | (110) |
| Child Care Credit | - | (250) | - | - |
| Net Liability | \$1,323 | \$1,293 | \$0 | \$0 |
| Total Household Liability | <u>\$2,616</u> | | <u>\$0</u> | |



Net PIT vs Personal Income

33.2%





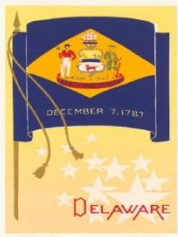
Net Franchise +LP/LLC Taxes

Cyclical Issues

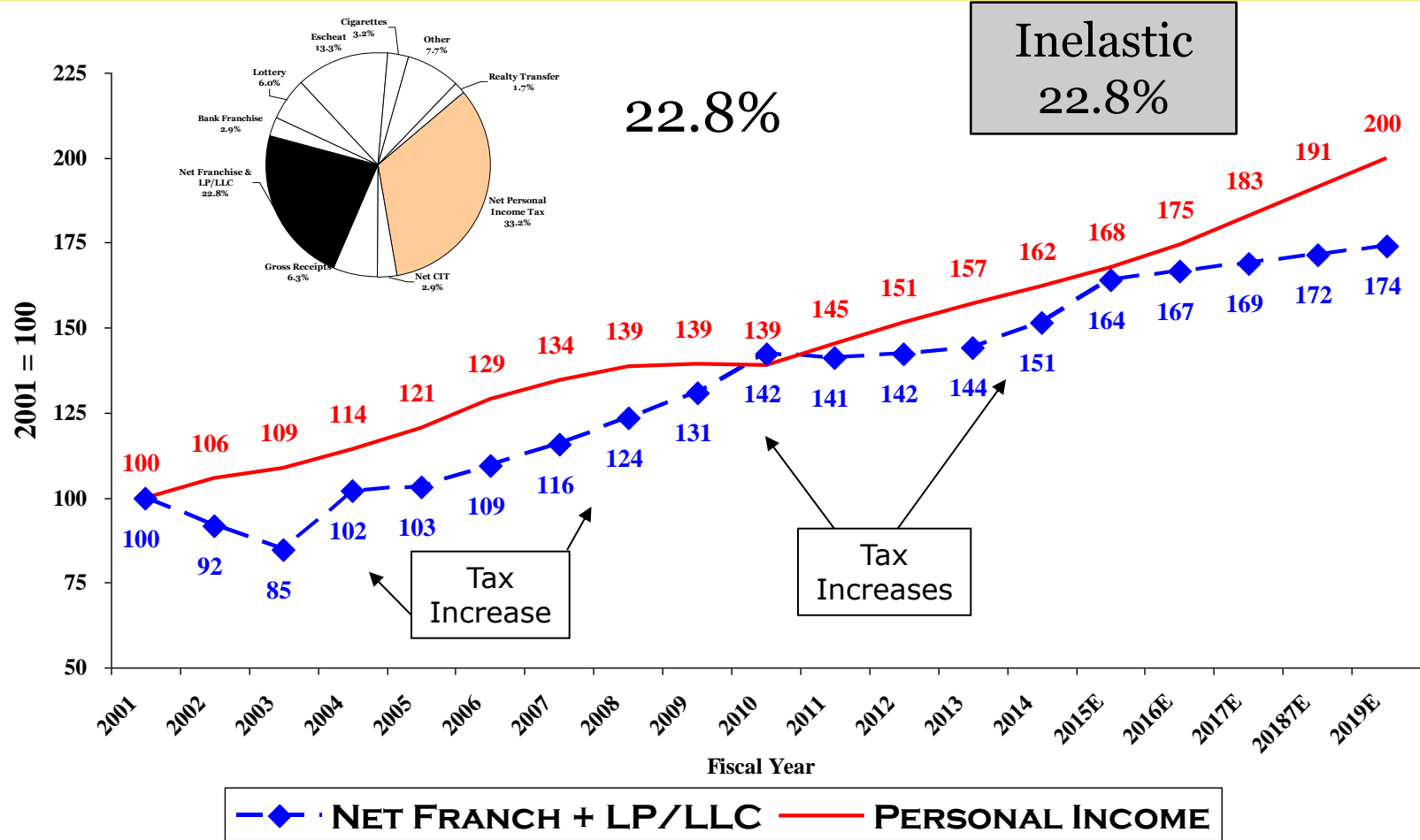
- Financial markets, esp. IPOs
 - Stock market
 - General economic conditions
- Business confidence

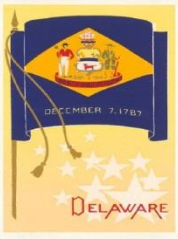
Structural Issues

- Max rate = no “natural” growth
- Structural - Alternative Entities – LLC’s
- Willing customers & competition



Net Franchise + LP/LLC vs Personal Income





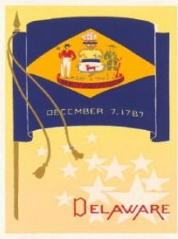
Bank Franchise Tax

Cyclical Issues

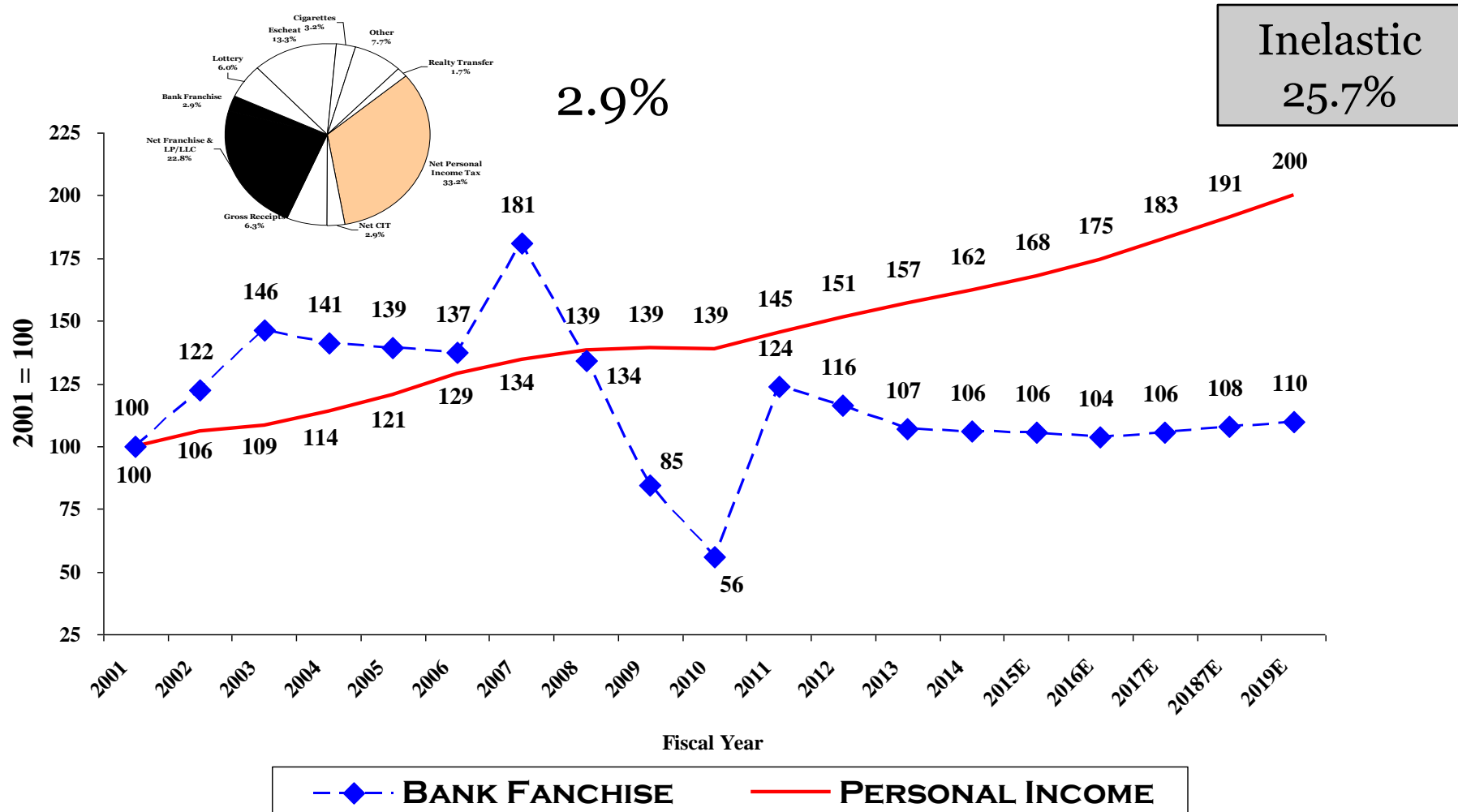
- Financial crisis
- Typically
 - Demand for Borrowed Funds
 - Cost of Money
 - Default Rates

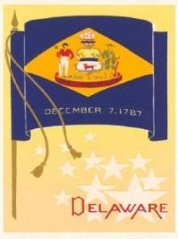
Structural Issues

- Regressive rates
- Demographics / consumption
- Small state -- Big banks
- Industry's post-crisis composition



Bank Franchise vs Personal Income





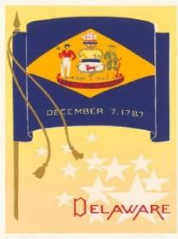
Corporate Income Tax

Cyclical Issues

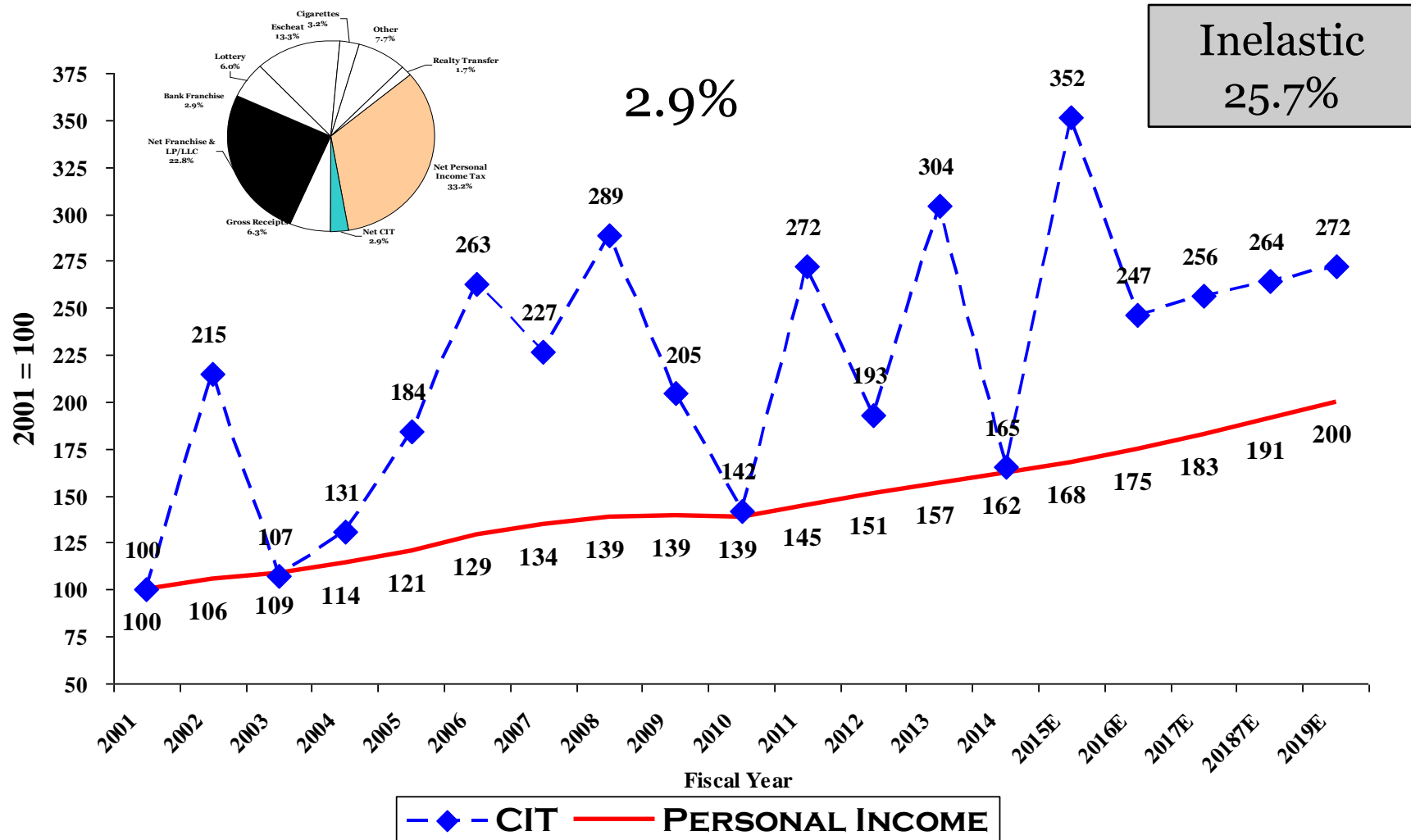
- Corporate profits vs. receipts
- Most volatile tax

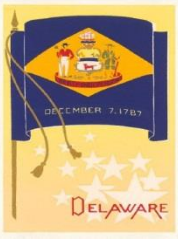
Structural Issues

- Small state, Big taxpayers
- Loss carry-forwards
- Federal piggyback



CIT vs Personal Income





Gross Receipts Tax

Cyclical Issues

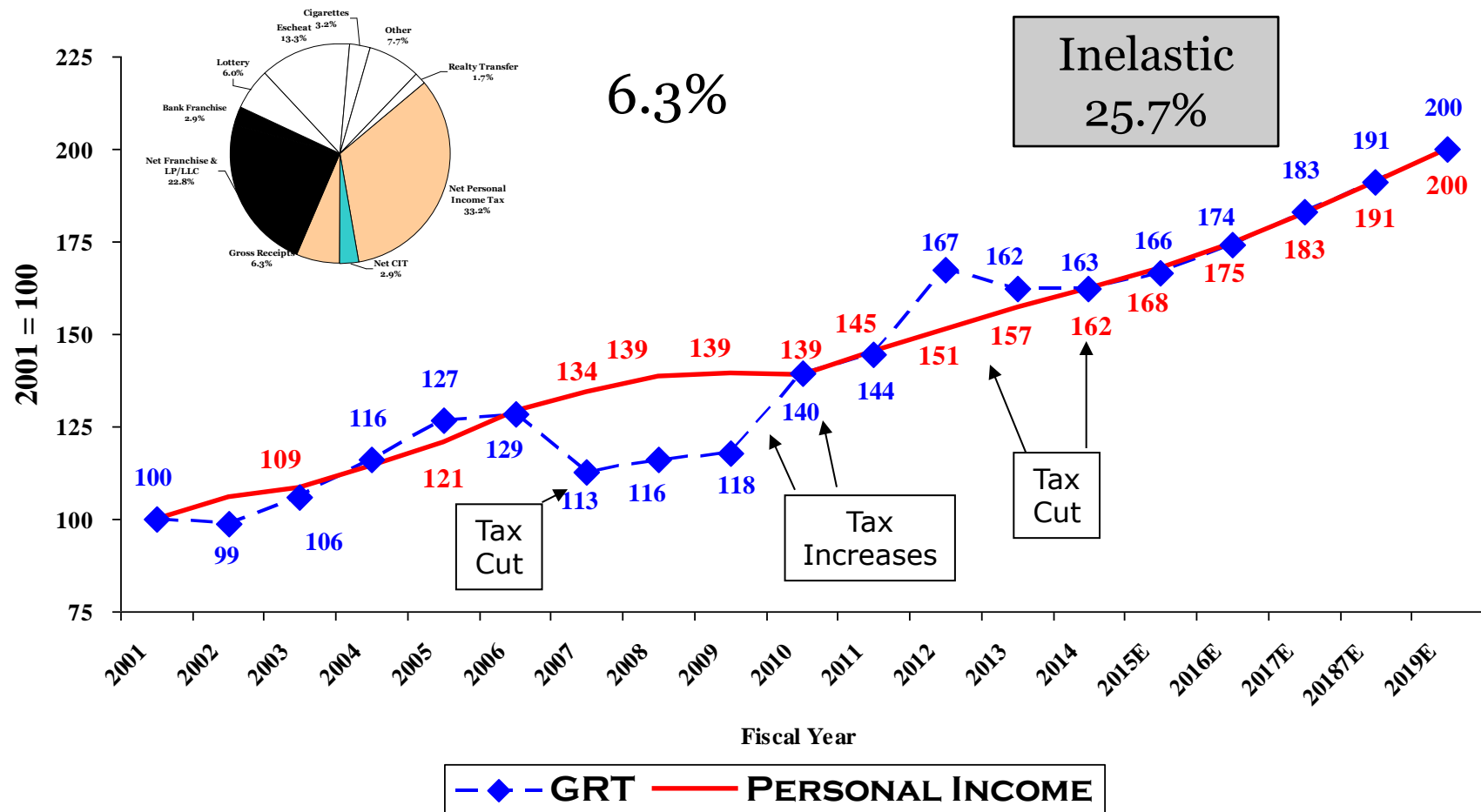
- Broad-based reflects economy
 - Consumers (Non-residents)
 - Oil prices
 - Construction

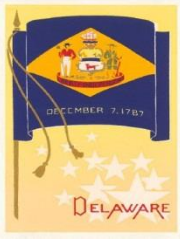
Structural Issues

- Few Issues
 - A bit top heavy



Gross Receipts vs Personal Income





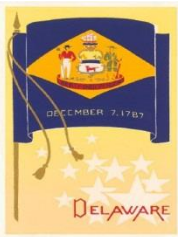
Lottery

Cyclical Issues

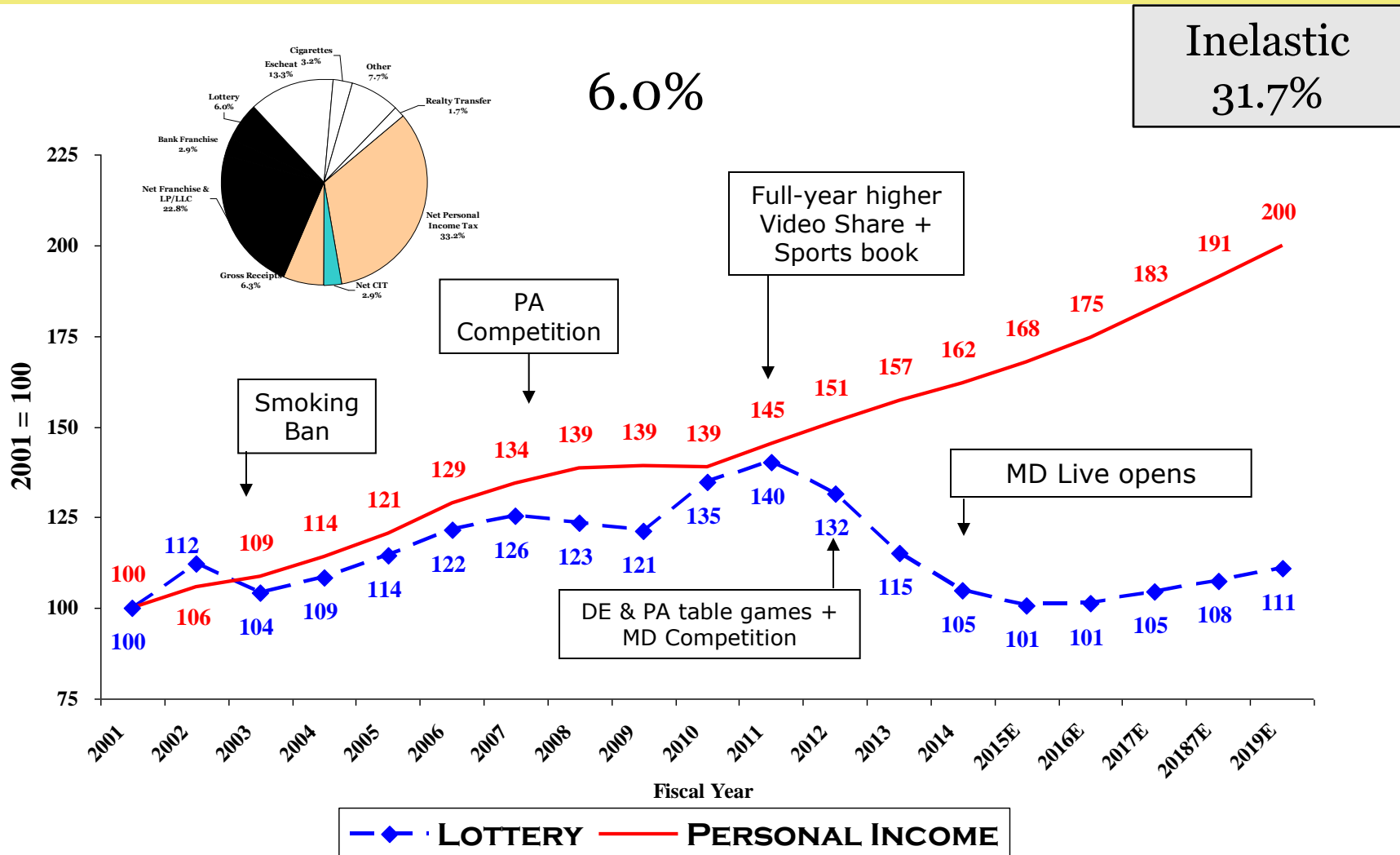
- Entertainment \$
 - Population growth
 - Disposable income

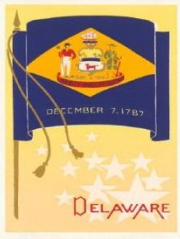
Structural Issues

- Regional Competition (MD, PA, NJ)
- Market Saturation Point?
- Business Model
 - Horse Racing Requirement
 - Sports Book/Table Games
 - Online Gaming Development
 - Investment Incentives



Lottery vs Personal Income





Escheat

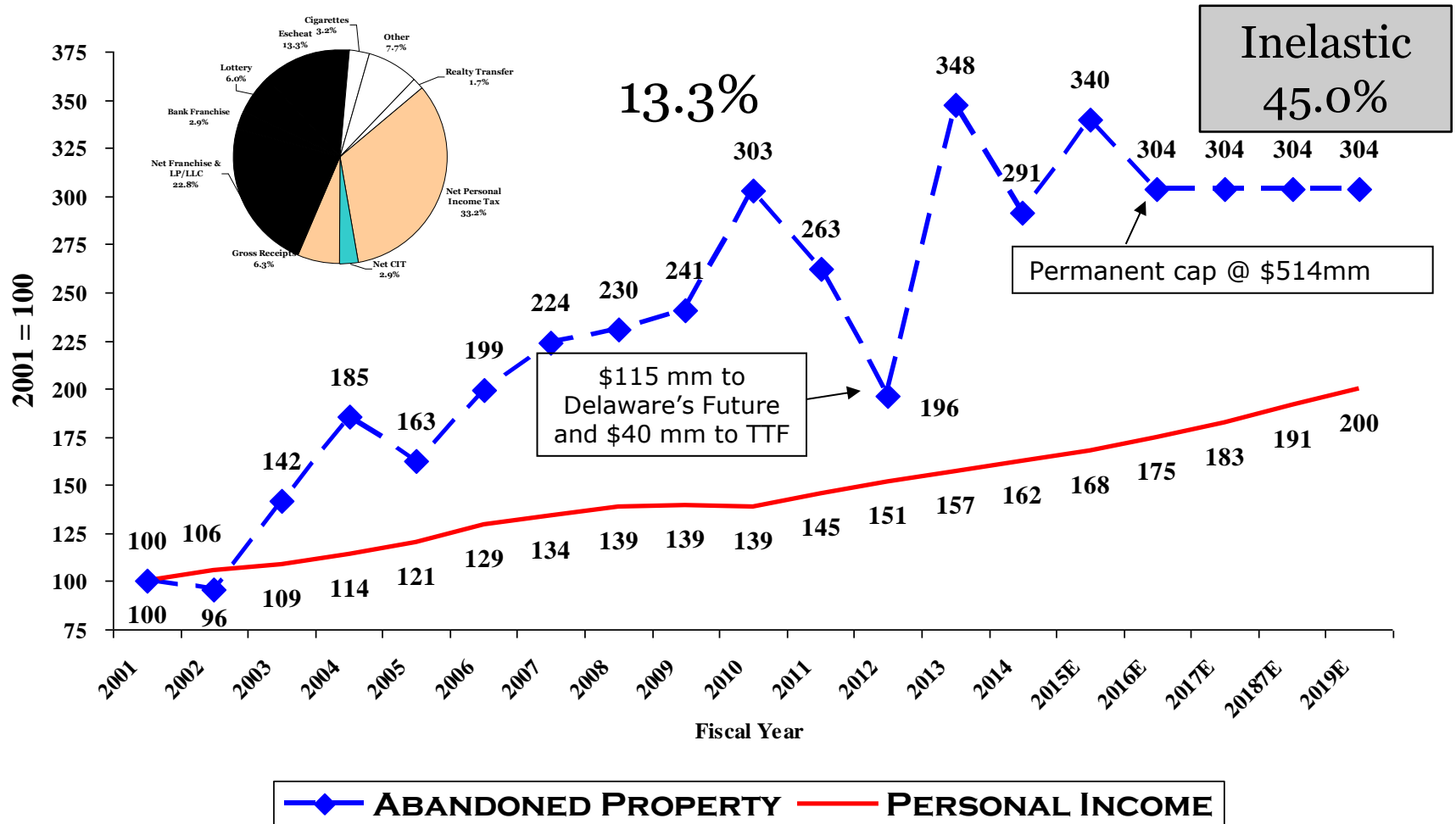
Cyclical Issues

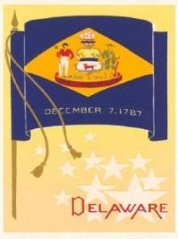
- Securities Markets

Structural Issues

- Legal environment
- Size of Lost Asset Universe?
- Big Enforcement \$
- Small community of experts
- Controversial

Escheat vs Personal Income





Realty Transfer Tax

Cyclical Issues

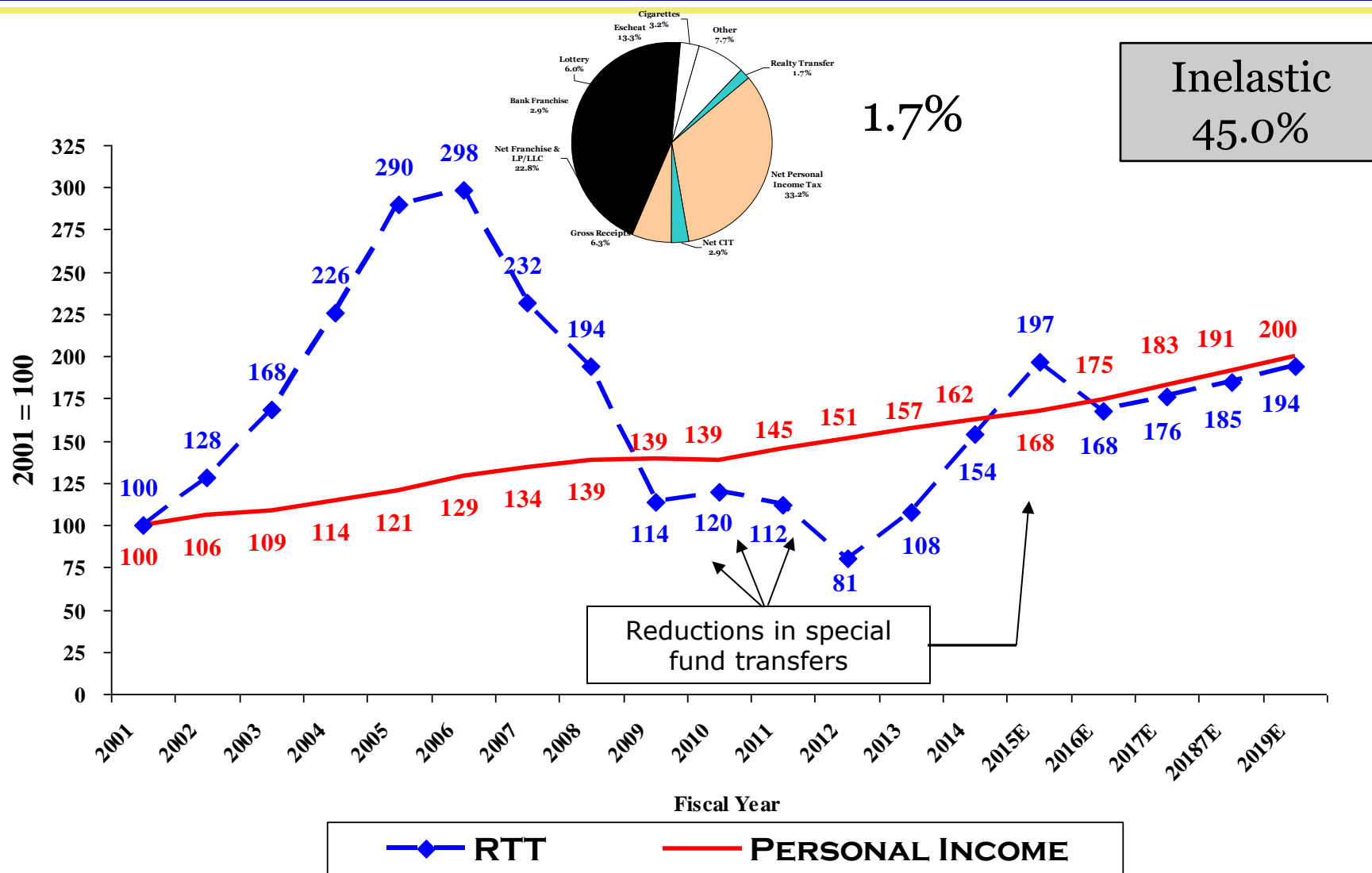
- Employment/Wage growth
- Household formation rate
- Private debt-to-income ratios

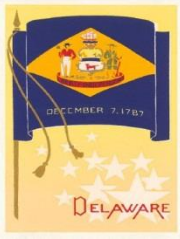
Structural Issues

- Trends in household formation



RTT vs Personal Income





Cigarette Tax

Cyclical Issues

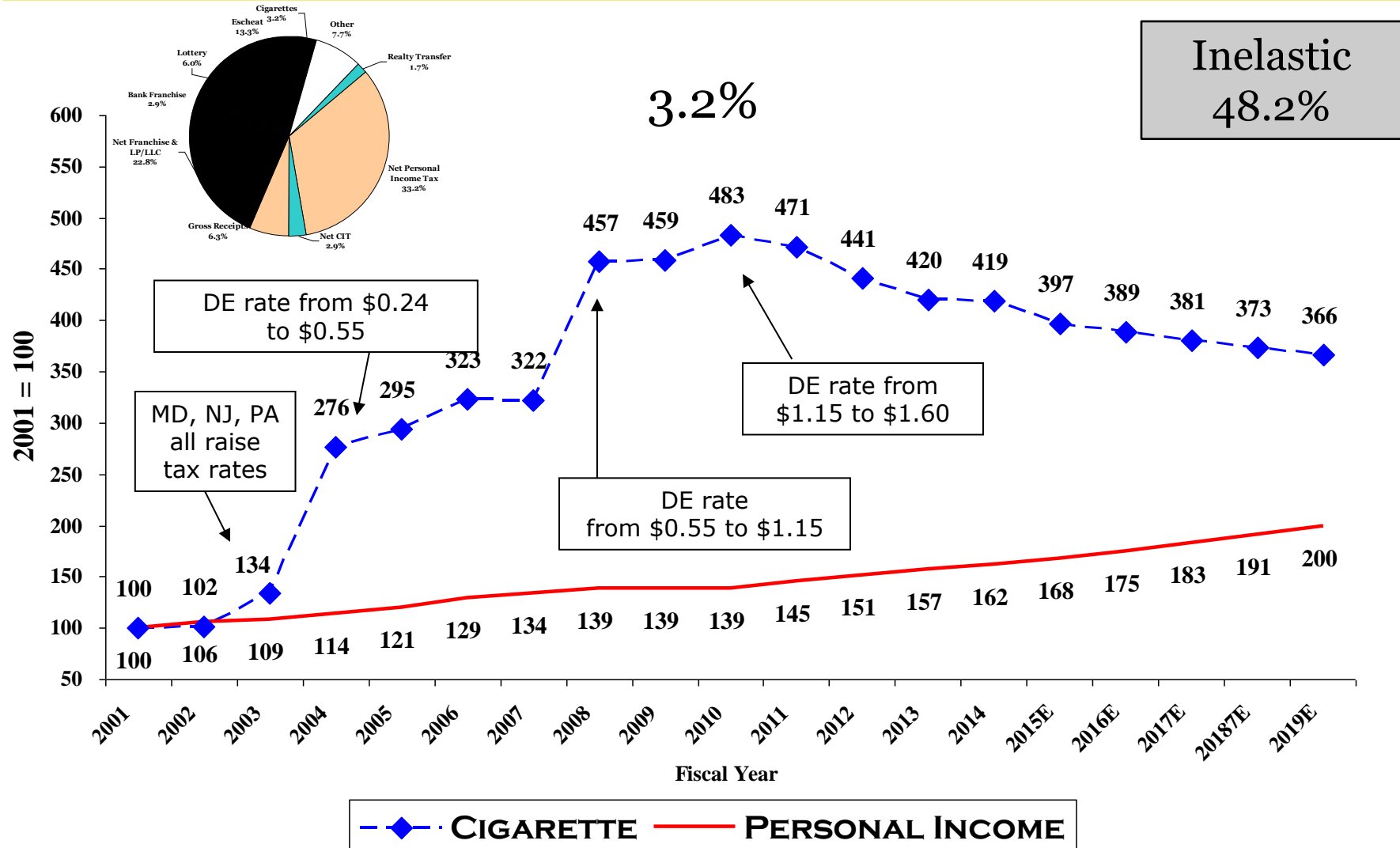
- Insensitive to economic trends

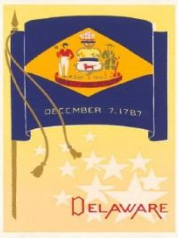
Structural Issues

- Declining national sales
- Increased substitute options
- Both revenue and discouragement



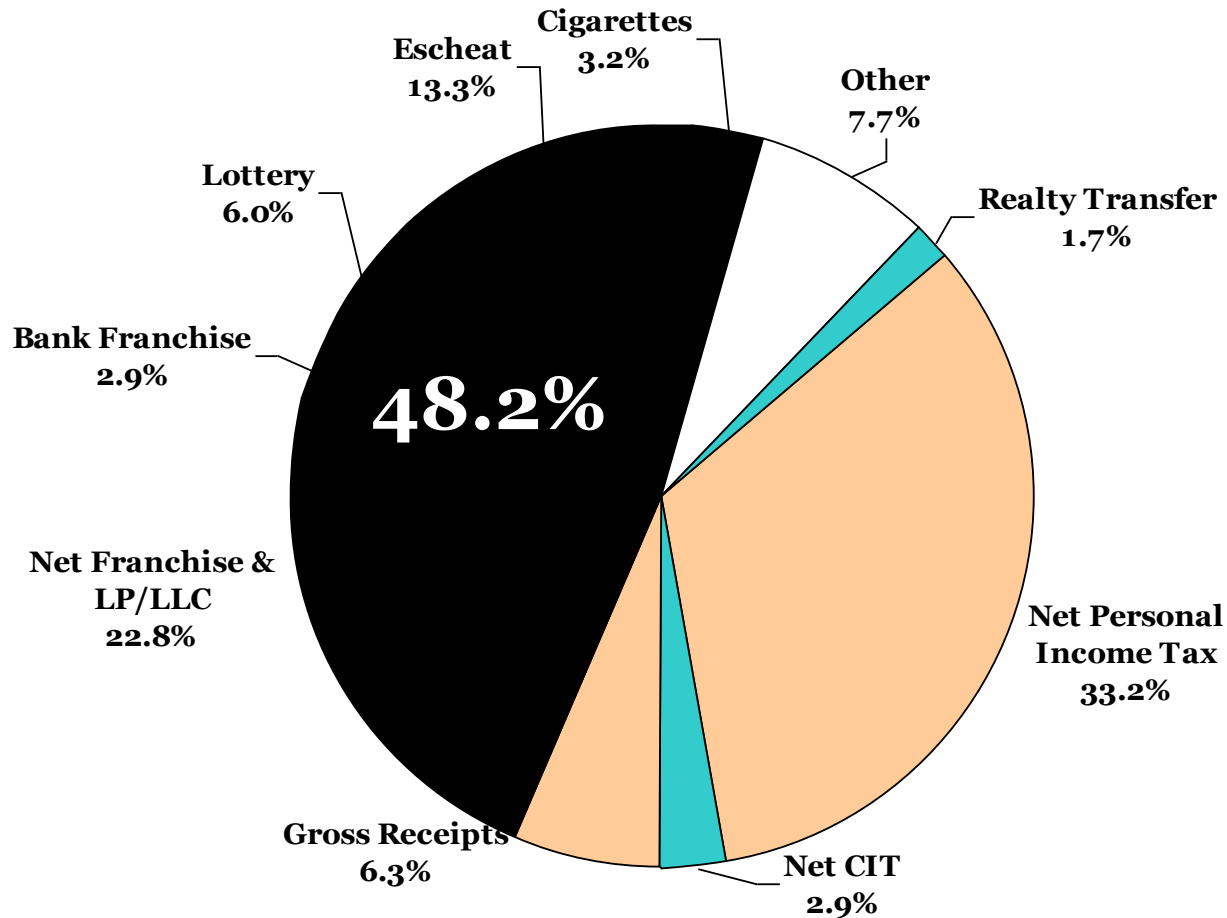
Cigarette Tax vs Personal Income

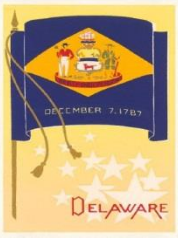




General Fund Revenues FY 2014

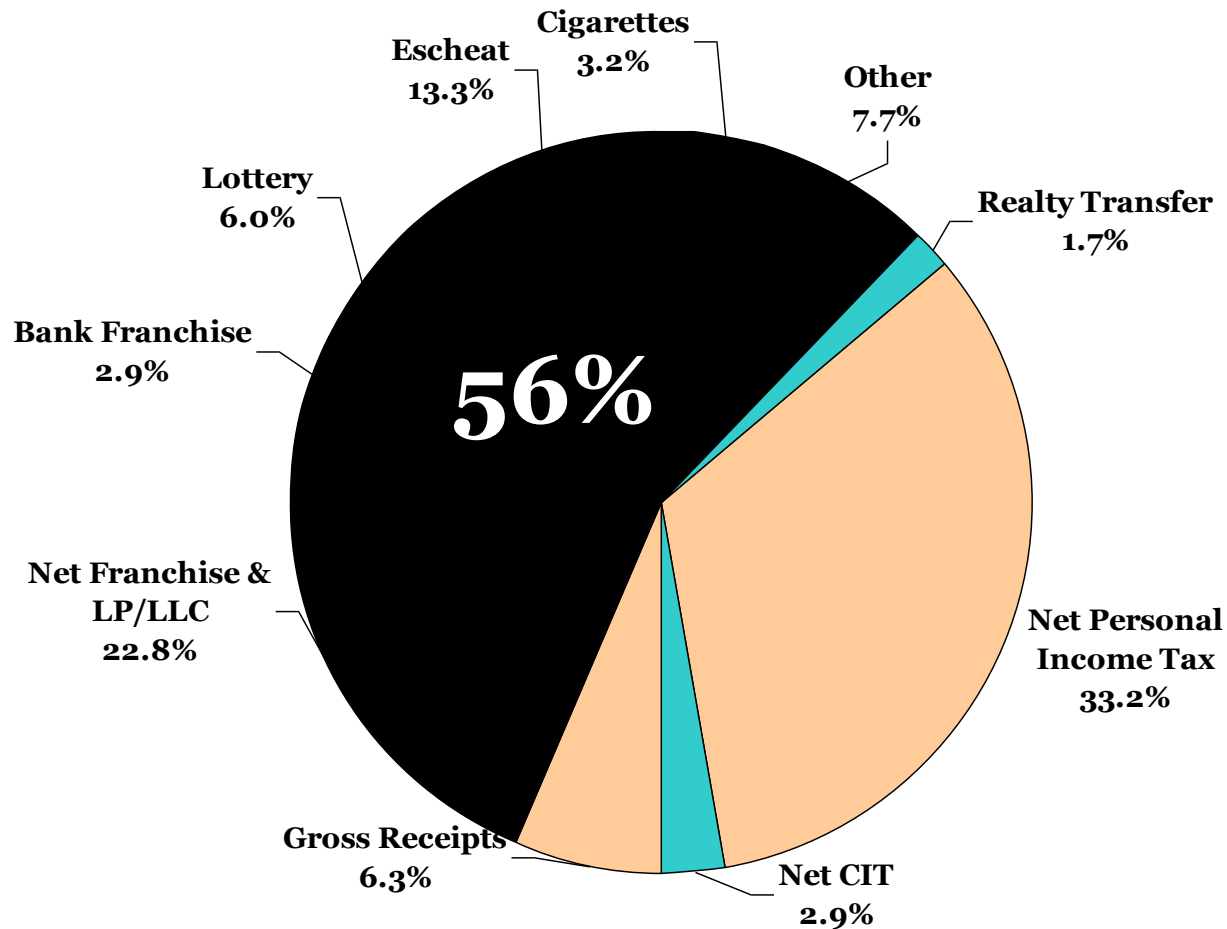
Total Revenue Net of Refunds: \$3,572.7 million.

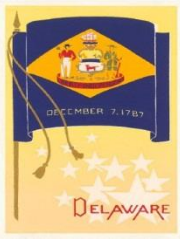




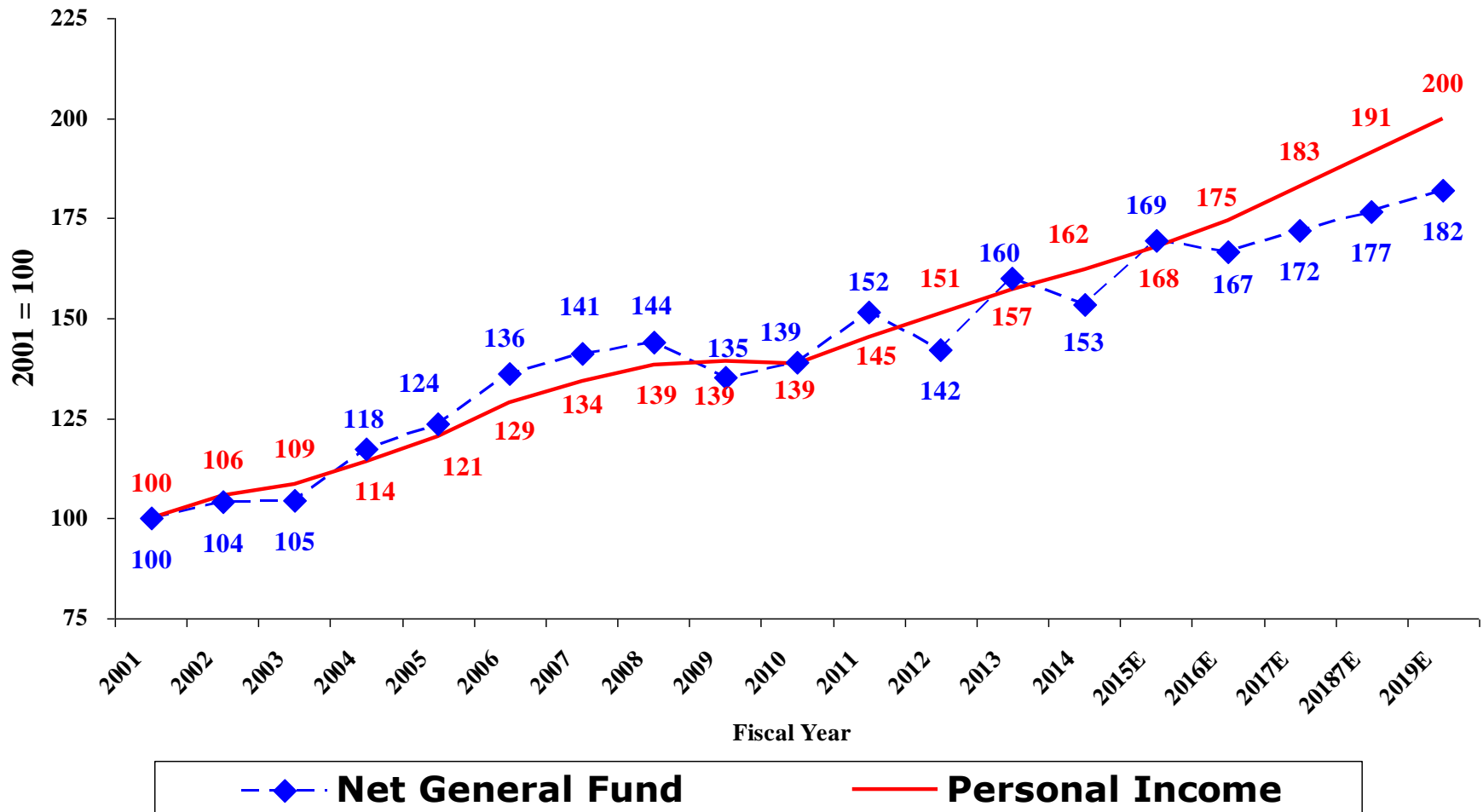
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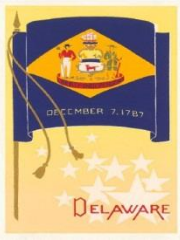




Net General Fund vs Personal Income



General Observations on Policy Options



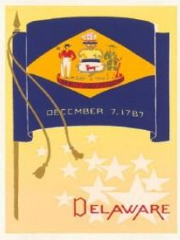
Context

- Compound Interest -- the most powerful force in the universe.
- If expenditure pressures are marginally higher than revenues – over time -- big problem
- Policy Response?
 - Continue on same path – statutory adjustments to exported, inelastic revenue sources
 - Change balance of portfolio so that state's funding needs are met, but require less frequent adjustments
 - Adding more elasticity
 - Limiting volatility
 - When evaluating these options, priority should be given those that have the best outcome with respect to DE's competitiveness



Revenue Policy “Levers”

- Large revenue sources have biggest opportunities / risks
- Rates and Base
- Reform individual revenues sources
- Rebalance sources in existing portfolio
- Look outside existing portfolio



Issue at Hand

